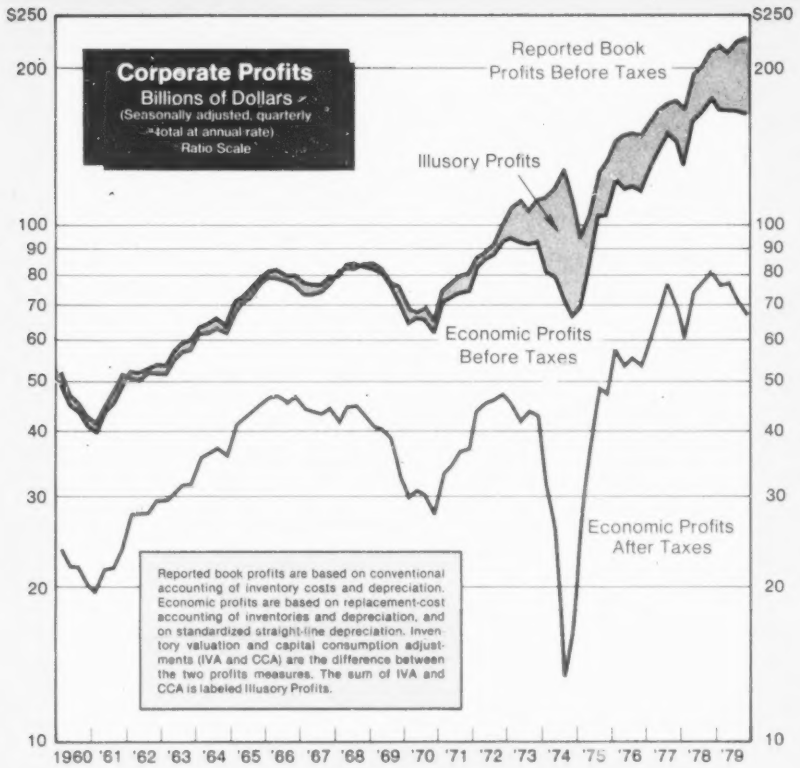
THE CONFERENCE BOARD

Profit Performance in Perspective

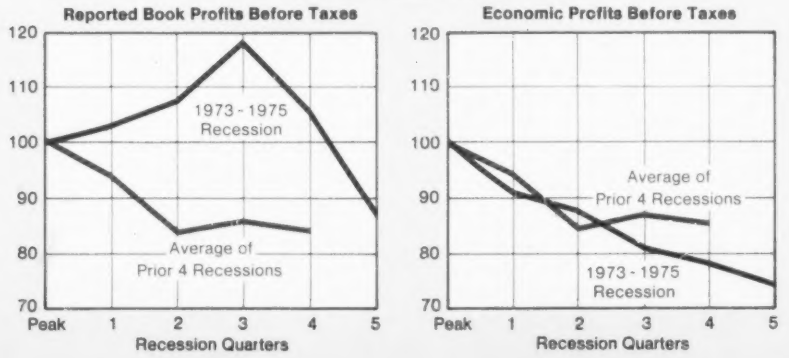
Economic Road Maps
No. 1879 May, 1980

Reported profits from corporate operations in the United States totaled $223 billion in 1979. This was a 14% gain from 1978. But one-fourth of these profits were "illusory," that is, reported as profits under conventional accounting procedures but not really available for payout as dividends or for investment in new capital. Illusory profits arise from accounting that understates the cost of providing for the replacement of the fixed capital and inventories used up in production. "Economic profits," that is, reported profits adjusted to eliminate this undercosting, were $165 billion in 1979, up only 5% from 1978. After taxes, economic profits dropped 1% last year to $72 billion.


Corporate Profits
Billions of Dollars
(Seasonally adjusted, quarterly total at annual rate)
Ratio Scale
Reported Book Profits Before Taxes
Illusory Profits
Economic Profits Before Taxes
Economic Profits After Taxes
Reported book profits are based on conventional accounting of inventory costs and depreciation. Economic profits are based on replacement-cost accounting of inventories and depreciation, and on standardized straight-line depreciation. Inventory valuation and capital consumption adjustments (IVA and CCA) are the difference between the two profits measures. The sum of IVA and CCA is labeled Illusory Profits.
$250
200
100
90
80
70
60
50
40
30
20
10
1960 '61 '62 '63 '64 '65 '66 '67 '68 '69 '70 '71 '72 '73 '74 '75 '76 '77 '78 '79

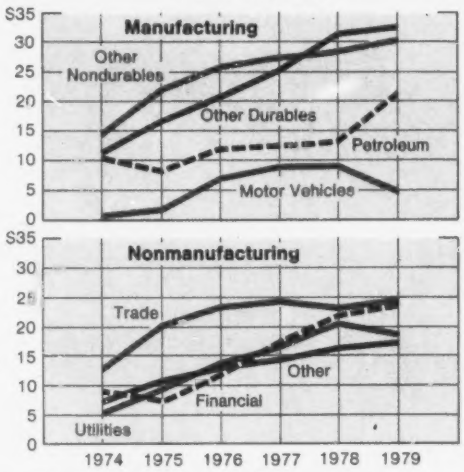
Profits in Recession

100 = Profits at Business Cycle Peak



Recent Profit Trends by Industry*

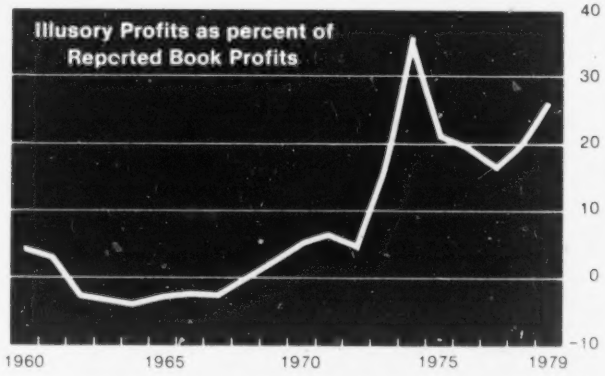
Billions of Dollars

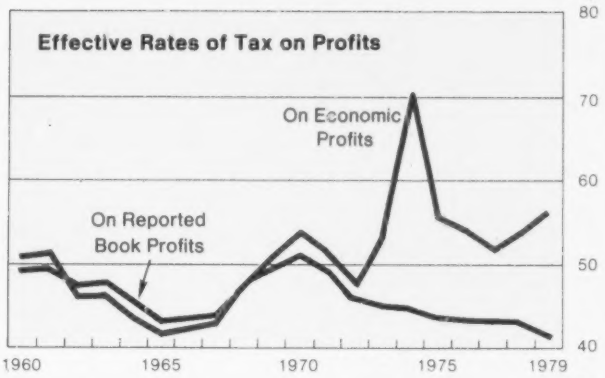


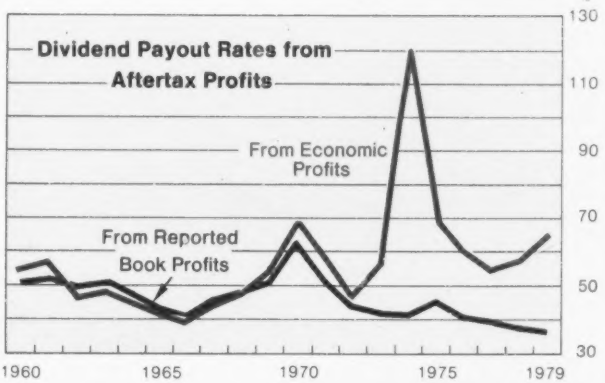
*Pretax profits adjusted to exclude illusory profits from undercosting of inventory, but not adjusted for underdepreciation. Financial excludes Federal Reserve Banks.

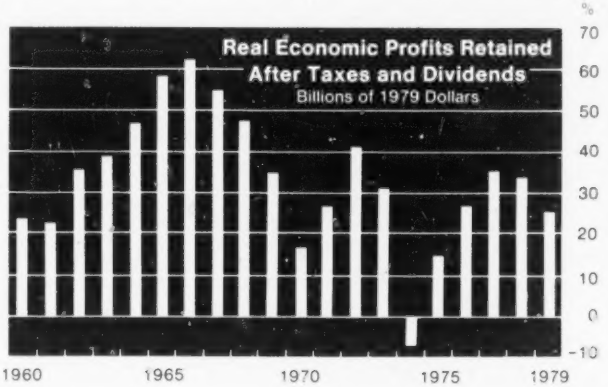
Public awareness of the "illusory profits" issue should increase because more than 1,000 large firms are required to begin this year to report financial data with adjustments for underdepreciation of fixed capital and undercosting of inventories. In an era of high inflation, this alternative accounting of replacement rather than historical costs can have a very big impact on some companies' income statements. The adjustment methods required this year are crude and the results are sometimes ambiguous, but there should nevertheless be a wider realization of the fact that some conventionally reported profits are indeed illusory.

Profits decline in recessions (chart at left). But in the 1973-75 slump, the pattern was defied as reported profits









"Illusory Profits"
(1978 data, billions of dollars)

1. Reported book depreciation	119.8
2. Less: Amount resulting from use of depreciation methods faster than straight-line	32.1
3. Equals: Book depreciation adjusted to straight-line basis	87.7
4. Plus: Amount to put straight-line depreciation onto replacement cost basis	45.2
5. Equals: Depreciation used in calculating economic profits	132.9
6. Net underdepreciation (line 4 minus line 2), or "Capital Consumption Adjustment"	13.1
7. Undercosting of inventories used up in production, or "Inventory Valuation Adjustment"	25.2
8. "Illusory Profits": line 6 plus line 7	38.3

continued to rise well into the recession. The reason is that "inventory profits"—those resulting from undercosting of inventories used up—were rising sharply in the highly inflationary environment of 1974. Economic profits, however, followed the typical recession pattern and declined.

Commerce Department data are used for what are here termed illusory profits. As shown in the table, reported historical-cost depreciation is first adjusted to put it on a "straight-line" basis, i.e., to deduct the effects of any accelerated depreciation formulas used. This is a conservative estimate of true economic depreciation, and it is this conservative figure that is then adjusted from an historical-cost basis to replacement cost. Without this conservative assumption, the estimate of underdepreciation, and thus of illusory profits, would be larger.

Companies are taxed on reported profits. This means that the effective rate of tax on their economic profits is considerably higher than the average tax rate on reported corporate profits. Likewise, the rate of dividend payout from after tax economic profits is considerably higher than the payout rate as conventionally calculated.

It is only after all costs are covered, including the replacement cost of the fixed capital and inventories used up in production, and after dividends are paid, that a company in principle has funds available for new capital investment. These funds—retained economic profits—totaled $25 billion in 1979. This was down 19% from 1978, or more than 25% when account is taken of the fact that a dollar bought less in 1979 than it had in 1978. In terms of their real purchasing power, retained economic profits in 1979 were less than half as large as in the mid-1960s.

Lora S. Collins

Sources: U.S. Department of Commerce, Bureau of Economic Analysis; The Conference Board.

ECONOMIC ROAD MAPS

Eva Culen, Editor Chuck N. Tow, Lead Chartist

Prepared in The Business Conditions Analysis Department—Lora S. Collins, Director
Prices for Quantities of this chart will be supplied on request to Information Service.

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International Currencies

Economic Road Maps

Nos. 1880 - 1881 June, 1980

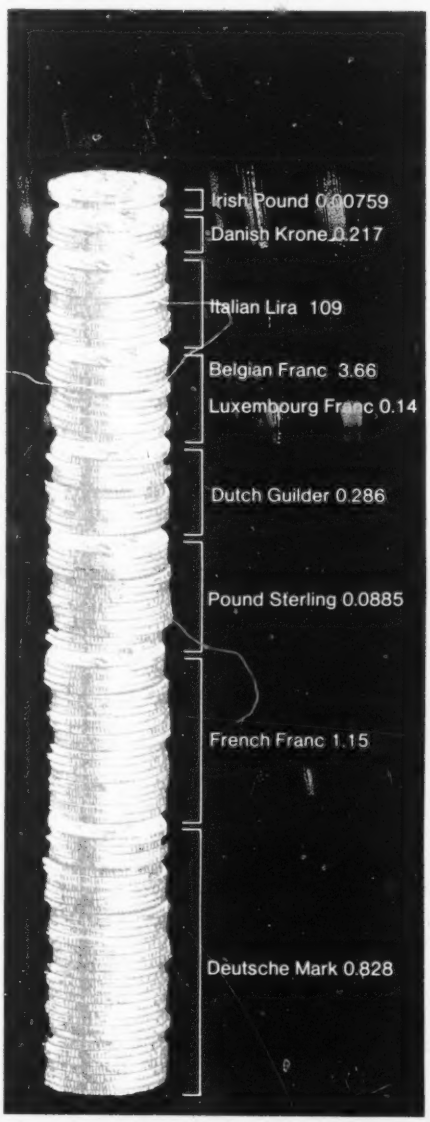
Every nation's currency is the unquestioned monetary standard within national borders: as a medium of exchange and also as a store of value (although inflation undermines that function). At the international level, things become more complicated as payments often involve flows of funds from one currency into another. Historically gold, and later the pound sterling and the U.S. dollar fulfilled the need for a universally accepted standard of value. A variety of international units of account have been created over the years but with scant international success. The two leading examples of such units are the SDR, which is broadly based and widely used at least in international accounting, and the new ECU of the European Community.

SDR Currency Basket

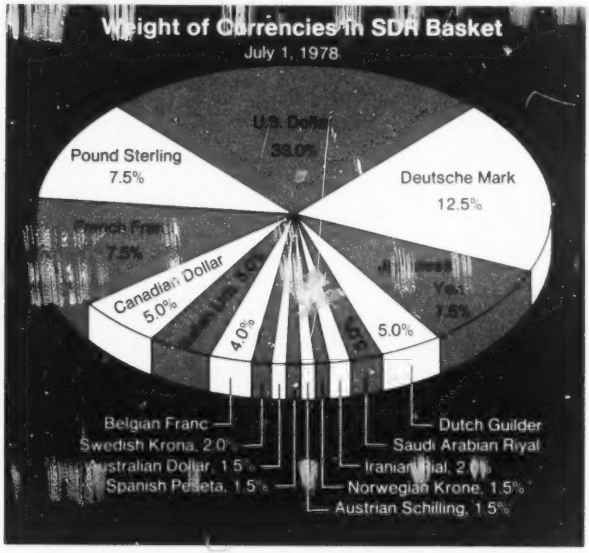
Methods to increase international liquidity in order to ensure a healthy expansion in world trade were at the center of official concern in the early 1960's. The supply of monetary gold could not be expected to grow, as production was stagnating while industrial demand was on the rise. The U.S. balance-of-payments deficit was shrinking, and consequently the dollar's share of international liquidity was not expected to grow at the rate of the earlier postwar years. The result of this concern was the creation of Special Drawing Rights (SDR) by the International Monetary Fund (IMF) in 1969. The SDR is an international reserve asset that is created by fiat and allocated by the Fund to its members. Three initial allocations were made by the Fund between January, 1970 and 1972. But by then the U.S. balance of payments was moving into deficit, with a resulting new abundance of dollars in world financial markets. As a result, no new SDR's were distributed until January, 1979 and 1980—with the final installment to come next January; it will raise the total outstanding SDR to 21.3 billion.

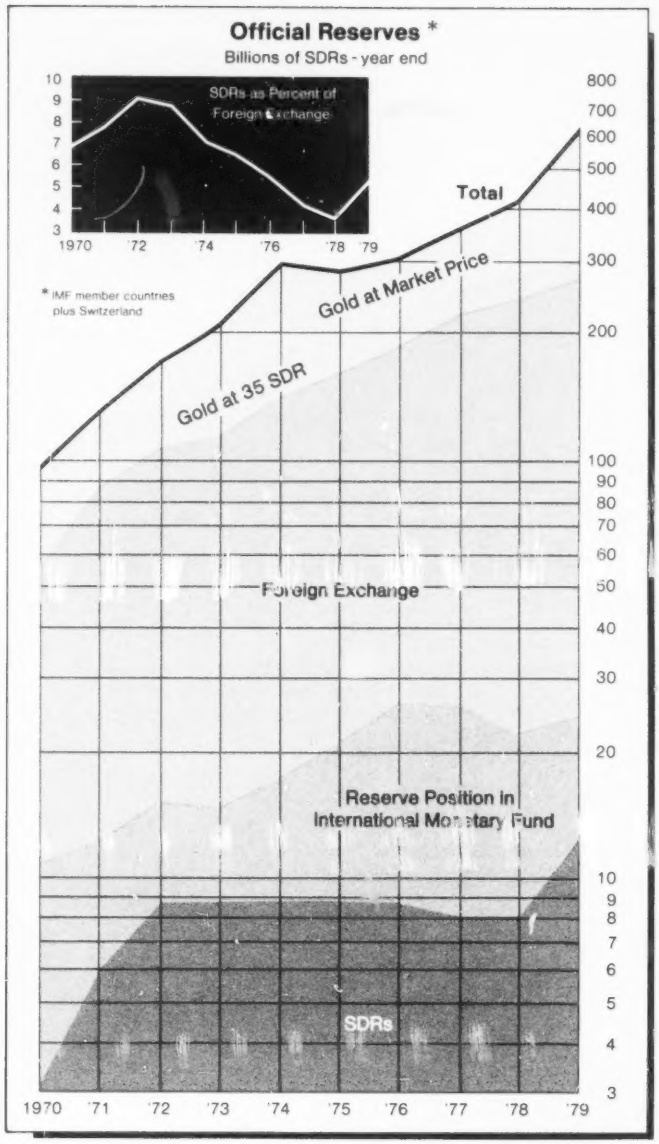
The SDR was launched in January, 1970, at a time of fixed exchange rates, and was at the time set equal to a fixed quantity of gold, specifically, the gold content of the dollar. Thus,

ECU Currency Basket



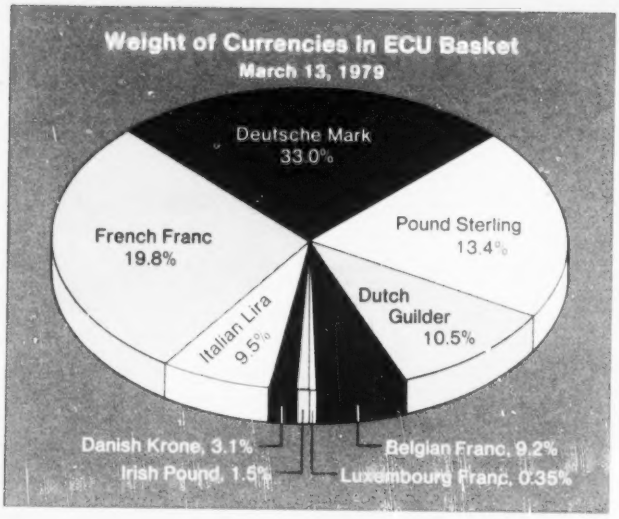
SDR1 equalled $1. Following the break of the gold-dollar link and two dollar devaluations, the SDR continued to be defined in terms of gold, but with gold's official price having risen from $35 to $42.22 per ounce, the dollar value of the SDR was now $1.206. Then on July 1, 1974, the method of valuation was changed to a "standard basket" formula. Under this method of a valuation, the SDR is equal to a total of fixed amounts of 16 currencies, whose weights in the basket have been assigned by international agreement. Currencies of all countries with a share in world exports of goods and services in excess of 1% during the period from 1968 to 1972 were included in the basket. The U.S. dollar was assigned a weight of 33% of the basket, to reflect its financial and commercial importance in international transactions. Lower percentages were assigned to the other 15 currencies in broad proportion to their shares in international trade. A further change in the composition of the SDR occurred on July 1, 1978 when the Danish krone and the South African rand were replaced by the currencies of Saudi Arabia and Iran. The weights were also adjusted in accordance with the 1972-1976 trade figures. The list of countries and weights is to be adjusted every five years.

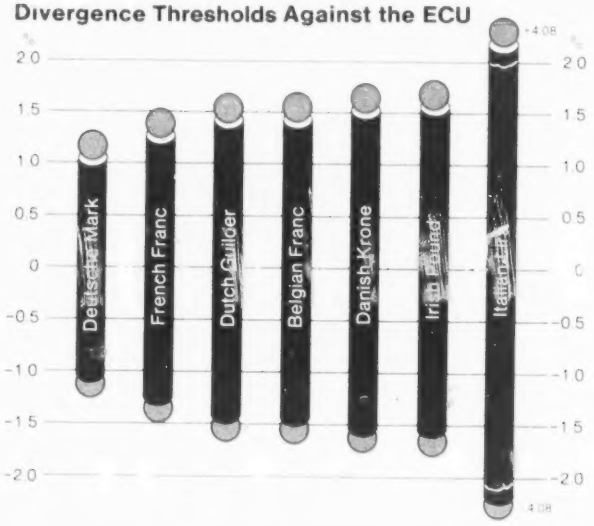



Official Reserves *
Billions of SDRs - year end
SDRs as Percent of Foreign Exchange
Total
Gold at Market Price
Gold at 35 SDR
Foreign Exchange
Reserve Position in International Monetary Fund
SDRs
* IMF member countries plus Switzerland
1970 '71 '72 '73 '74 '75 '76 '77 '78 '79

The SDR is the official unit of account of the IMF, and loans by the Fund are SDR-denominated. Countries can use SDR's when borrowing from the Fund to settle payment deficits. They can also be used to settle obligations without changing them into currencies; they can be lent, and they can be pledged as security for a loan by a central bank or government.

The European Monetary System or EMS came into being on March 13, 1979. Membership consists of the EEC countries with the exception of Britain. Its purpose is to create an expansionary climate for trade and economic growth in the EEC by limiting disruptive foreign ex-



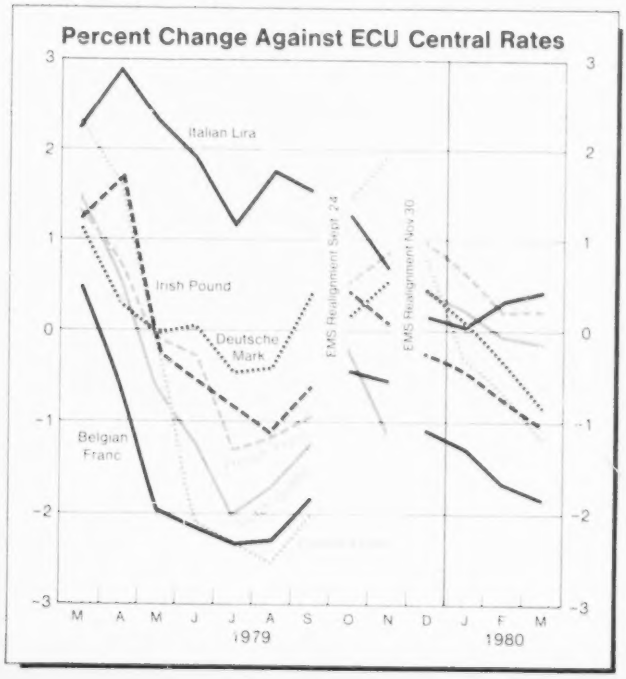


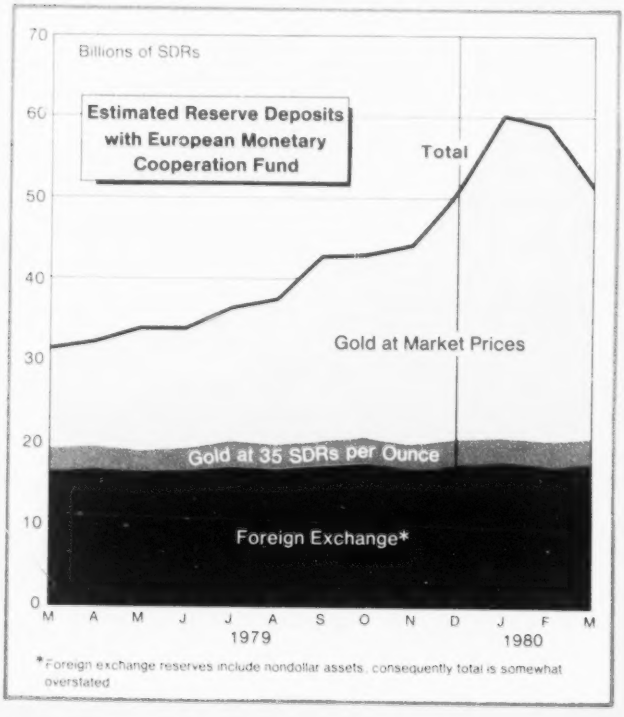
change fluctuations. At the center of the system is the European Currency Unit (ECU). The ECU consists of a basket of EEC currencies, the amount of each currency reflecting the importance of the economy it represents. Britain is not a member of the EMS, but the British pound is part of the ECU. The composition of the ECU can be changed by mutual agreement. It was originaly stipulated that the basket could be revised after a period of six months, and every five years thereafter. In case the weight of any currency has altered by more than 25%, an adjustment can also be made.

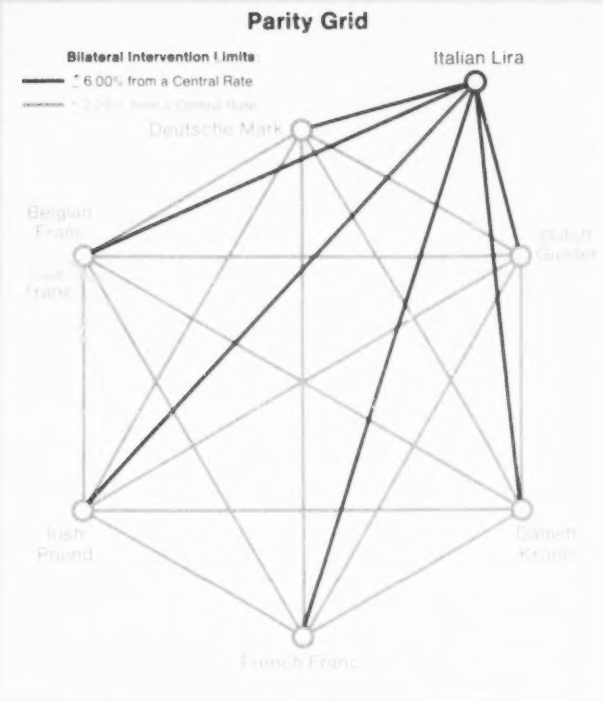
The main functions of the ECU are: (1) to serve as a denominator (numeraire) for fixing central exchange rates for individual currencies; (2) as a basic indicator of whether a currency is "diverging"; (3) as a unit of account for central bank operations in the market; and (4) as a means of settlement between monetary authorities.

All member currencies (excepting the pound sterling) are assigned an ECU-related central rate expressed as a certain quantity of currency per ECU. The linking together of these central rates results in a series of bilateral central rates for each pair of currencies; this constitutes the *parity grid*. Currencies are allowed to fluctuate around these bilateral central rates by a margin of plus or minus 2.25 percent. The exception is the lira, which can move 6% in each direction. When the intervention point between two currencies is reached, the central banks of the two countries concerned intervene in the currency which threatens to exceed the margin.

A further restraint on currency movements is exercised by the *divergence indicator*, which measures the degree of movement of a specific currency against its maximum divergence spread. One has to keep in mind that the ECU-related central rate is a fixed value, while the market rate of the ECU fluctuates, and as a result a currency can be either at a premium or at discount

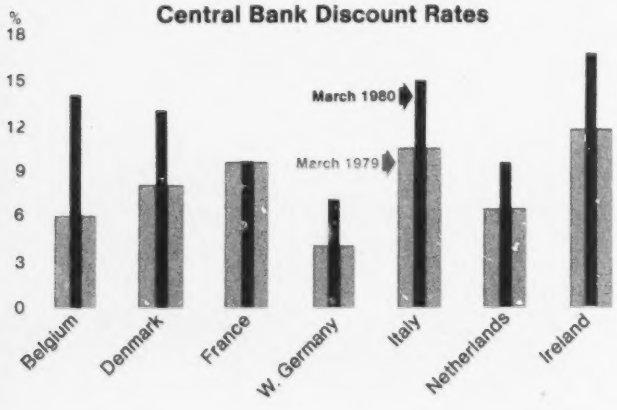


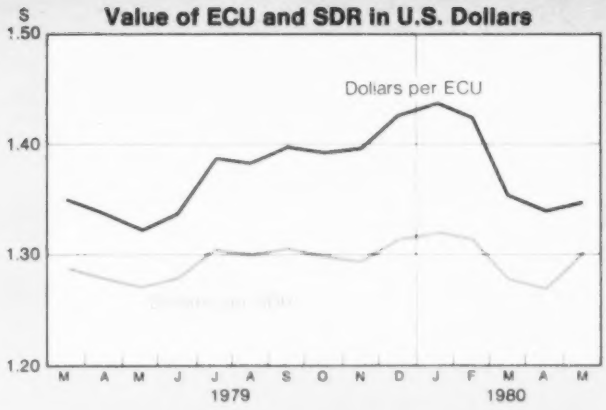

Billions of SDRs
Estimated Reserve Deposits with European Monetary Cooperation Fund
Total
Gold at Market Prices
Gold at 35 SDRs per Ounce
Foreign Exchange*
M A M J J A S O N D J F M
1979
1980
*Foreign exchange reserves include nondollar assets, consequently total is somewhat overstated



against its ECU-related central rate. By calculating the premium or the discount shown by the market rate of the ECU in terms of a currency against its ECU-related central rate and then comparing the results with the maximum divergence spread one obtains the divergence indicator. The divergence indicator is different for each currency, and depends on its weight—the greater a currency's weight, the lower the divergence threshold and vice versa. A currency reaches its divergence threshold when the appreciation or depreciation in the market rate of the ECU in terms of a given currency reaches 75 percent. Once a currency crosses its threshold, there is a presumption (although not an obligation) that suitable measures will be taken by the country's monetary authorities.

The European Monetary Fund, which is to serve as a central bank, is not expected to come into existence until

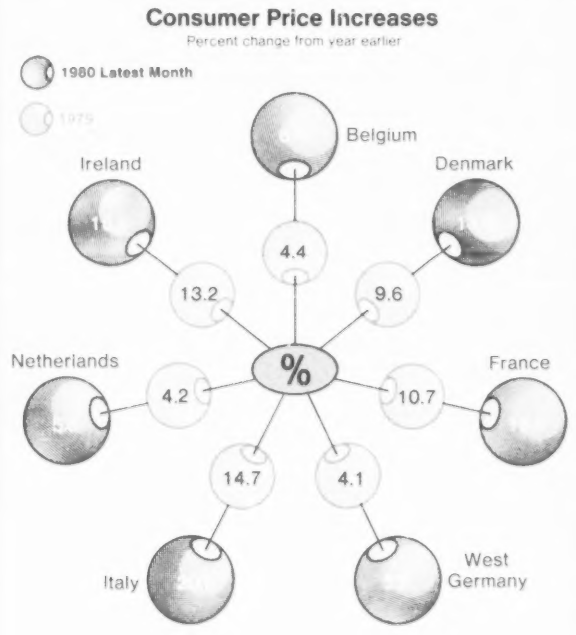




1981 or even later. In the meantime the European Monetary Cooperation Fund "receives monetary reserves from member states and issues ECU's against such assets." The central banks of all participating countries have deposited with the EMCF 20% of their gold and 20% of their U.S. dollar reserves against the issue of ECU's. The gold is valued at the average market price of the previous six months. The transactions take the form of a swap and run for three months. The swap however is only a bookkeeping exercise as each central bank continues to manage the reserves it has deposited with the EMCF.

Eva Cullen

Sources: IMF; Commission of the European Communities; Citibank; The Economist; The Conference Board.



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